In the

Supreme Court of the United States

OCTOBER TERM, 1944

No. .....

AMERICAN LIBERTY PIPE LINE CO.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

OPINIONS OF THE COURTS BELOW

The opinion of The Tax Court of the United States is reported in 2 T. C. 309. It is also printed in full in the record. (R. 31-50.)

The opinion of the Circuit Court of Appeals for the Fifth Circuit is reported at 143 Federal Reporter (2d) 873, and is printed in full in the record at pages 176-182.

JURISDICTION

The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code (28 U. S. C. 347). The Circuit Court of Appeals has in this case "rendered a decision in conflict with the decision of another Circuit Court

of Appeals on the same matter." [Supreme Court Rule 38(5)(b)].

Judgment was entered in this case by the Circuit Court of Appeals on July 14, 1944. (R. 176.)

On motion of the petitioner the time for filing this application was extended to November 25, 1944, by order dated October 14, 1944 and signed by Mr. Justice Hugo L. Black.

STATEMENT OF THE CASE

There are no controverted fact issues in the case. In 1935, three individuals who owned several pipe line gathering systems, by virtue of stock ownership in corporations owning such systems conceived the idea of unifying such systems and extending their unified pipe line system some 160 miles to deep water. (R. 64.) In order to accomplish this purpose they proposed to organize a corporation to be known as American Liberty Pipe Line Co., to which would be transferred all of their various pipe line systems and which would construct the additional 160 miles of pipe line. To accomplish such consolidation and extension it was necessary that arrangement be made to borrow a large sum of money. After investigation of the cost of the project and oral discussions with the officers of the Republic National Bank & Trust Company of Dallas, the promoters of the proposed corporation addressed a letter to such Bank on November 5, 1935, setting out the proposed transaction and offering to sell $1,250,000.00 first mortgage 2-year 6% notes, payable quarterly out of three-fourths of the earnings of such proposed corporation, to the Bank. (R. 65; Ex. 1, R. 93-96.)

By letter of November 21, 1935, the promoters again offered to sell such note issue to the Bank. (Ex. 2, R. 97.) This letter set out the proposal in detail, stating the estimated cash requirements for the proposed improvements, and stated further that the promoters proposed to create a first mortgage on the lines to be built by and on those to be conveyed to the new corporation, in the sum of $1,250,000.00 to be evidenced by notes bearing date as of the date of the completion of the new construction and to be due two years after date. It was further stated that the notes were to be further secured by three-fourths of the net earnings of the Pipe Line Company. (R. 99.) It was further stated that in order to make their plans it was necessary to obtain the commitment of the Bank to take the note issue when issued after completion of the pipe line. (R. 102.)

In response to this letter the Bank, on December 13, 1935, agreed to purchase such note issue subject to certain provisions contained in its letter of commitment of that date. (Ex. 5, R. 104.) One provision was that none of the gross income of the corporation should be spent except for actual and necessary operating expenses and taxes, and that the balance remaining should be applied monthly to the discharge of the debt. Another was that the project should be completed, and accepted by the Bank prior to June 30, 1936. (R. 109, 110.)

All the interested parties, including the Bank knew, at all times, that the commitment of the Bank was essential to the financing of the proposed project. (R. 72 and 73.) Not until June 18, 1936, was the project completed and

the notes issued and purchased in pursuance of the contract entered into between the Bank and the promoters. (R. 73.) Petitioner was incorporated under the laws of Delaware on December 27, 1935, and obtained a permit to do business in Texas on January 16, 1935. (R. 66, 67.) All of the negotiations, however, entered into by the promoters prior to the date of its incorporation were conducted for the benefit of petitioner. (R. 71.)

Credit was obtained from the contractors and suppliers, by the petitioner on the basis of the commitment of the Bank in its letter of December 13, 1935. (R. 72.) The American Liberty Oil Company expended $200,000.00 for petitioner on the basis of that commitment. (R. 72, 73.) Petitioner agreed to assign and Fredell Construction Company agreed to accept a portion of such commitment in payment for its construction work. (Ex. 9, R. 115-118.) Acting for petitioner the promoters assigned out of this commitment: to the National Supply Company an amount sufficient to liquidate their supply and construction account (R. 122), which ultimately amounted to $532,039.02 (R. 145); $42,000.00 to Liberty Pipe Line Company (R. 125); to Oil Well Supply Company the sum of $152,000.00. (R. 118, 119.) Each such assignment was irrevocable, and was made after the organization of petitioner, by the petitioner in one case, and by its officers acting for it in each other instance. The petitioner having performed its agreement fully, notified the Bank of such performance and on June 18, 1936, the deed of trust was executed and the money paid over to the petitioner in accordance with the terms of the letter of commitment. Immediately thereafter petition-

er paid out practically all of the $1,250,000.00 proceeds of the loan to its assignees, in accordance with its agreements. (R. 73.) Thereafter payments out of the earnings of petitioner were made to the Bank monthly, in strict compliance with the terms of the original contract represented by the Bank's letter of commitment and the deed of trust. (R. 83.)

Your petitioner takes the position that when the Bank accepted the offer of its promoters to sell mortgage notes to be issued by petitioner, a written contract was executed and that when it assigned portions of the proceeds of the loan to become available under the terms of the Bank's letter of commitment it thereby adopted and became a party to and executed a contract in writing, and bound itself to pay a debt which it then incurred, out of its earnings—a contract which required such payment during the taxable years here involved, and which was executed by petitioner prior to May 1, 1936, within the plain terms of Section 26(c)(2) of the Revenue Act of 1936.

ERRORS RELIED UPON

1. The Circuit Court of Appeals erred in holding that the contract upon which petitioner made payments was neither in existence nor executed by petitioner until after May 1, 1936.

2. The Circuit Court of Appeals erred in holding that execution of the deed of trust of June 18, 1936 constituted a new contract and that the debt on which the payments were made was not in existence prior to May 1, 1936.

ARGUMENT

POINT I

The contract relied on was in existence and was executed by petitioner prior to May 1, 1936, within the meaning of Section 26(c)(2) of the Revenue Act of 1936.

Section 26(c)(2) of the Revenue Act of 1936 reads as follows:

> "SEC. 26. CREDITS OF CORPORATIONS.
>
> "In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing the tax * * *.
>
> "(c) CONTRACTS RESTRICTING PAYMENT OF DIVIDENDS.
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> * * * * *
>
> "(2) DISPOSITION OF PROFITS OF TAXABLE YEAR.
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> "An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by a corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936."

The Circuit Court of Appeals, in speaking of the decision of The Tax Court, says:

> "We think it too clear for argument that the court was right in its conclusion that the contract under which the actual payments were made was neither in existence nor executed by petitioner until after May 1, and because it was not the claim fails."

In thus denying the existence of a contract the court is directly in conflict with the Circuit Court of Appeals for the Sixth District in the case of *Glenn v. Chess & Wymond*, 132 Fed. (2d) 621. The facts in that case are fully set out in the opinion of the District Court reported at 40 Fed. Supp. 666. In that case the plaintiff claimed credit upon undistributed profits, predicated upon a contract restricting payment of dividends in accordance with the provisions of Section 26(c)(1) of the Revenue Act of 1936. The bank offered to extend credit on certain conditions. The president of the taxpayer corporation (who simply signed his name individually, and without identifying his official relationship to the corporation) wrote a letter thanking the bank for its coöperation. The conditions in the bank's offer were fulfilled and the credit extended. One of the statements in the letter, and the only restriction on the payment of dividends in the entire contract was a statement in the bank's letter offering credit that the bank "would definitely oppose the payment of such dividends, however, should the earnings fall under $30,000.00 per quarter."

The court held that the letter of appreciation written by the president of the corporate taxpayer, constituted an acceptance of the bank's offer and that the two letters to-

gether constituted a binding contract that the taxpayer would not pay dividends except in accordance with such letter of the bank saying:

> "* * * While the phrasing of the offer could have been clearer, it must be understood and construed as an express provision that the credit was offered on condition that no dividends would be paid unless the earnings exceeded the given amount."

A much stronger case is here presented than that in the *Chess & Wymond case*. Here, it is true, the contract was in the first instance entered into between the promoters and the bank, prior to the incorporation of petitioner. That was merely the first step in the execution of this contract by the petitioner. One of the conditions of the contract was that petitioner should be incorporated. It is abundantly clear that the entire contract was made by the promoters for the benefit of the petitioner, and that the bank recognized this fact. The petitioner was incorporated and immediately proceeded to carry out the terms of the contract with the bank by entering into various contracts of construction, supply and purchase.

It had no assets other than the agreement of the bank to finance its construction and purchases. It was therefore necessary to adopt and the petitioner did adopt the contract of its promoters, substituting itself for them as the obligor to the bank, and assigning various portions of the bank's commitment to them in return for their supplies and work. From the moment that it adopted such contract by assigning portions of it in writing, that contract became the contract of this petitioner, and was executed by it under

the holding of the court in the case of *Glenn v. Chess & Wymond*, 132 Fed. (2d) 621, and within the meaning of Section 26(c)(2), Revenue Act of 1936.

The contract was therefore in existence prior to May 1, 1936.

POINT II

The debt upon which petitioner made payments was in existence prior to May 1, 1936.

The Circuit Court of Appeals held that the debt upon which the payments were made was not in existence prior to May 1, 1936, and stated:

> "* * * We think it quite plain too that The Tax Court was right in holding that whatever might have been said of Taxpayer's case, had its obligations for supplies and construction been simply renewed or extended, this did not occur here. On the contrary, there was a complete discharge of those debts with the making of a new contract with a new creditor, and our decision in Houston Cotton Exchange Bldg. Co. v. Comm., 134 F. (2d) 323, is controlling."

In making this decision the court has rendered a decision in conflict with the decision of the Circut Court of Appeals for the Seventh Circuit on the same matter in the case of *Commissioner of Internal Revenue v. Haskelite Mfg. Corporation*, 128 Fed. (2d) 902, and insofar as the court refuses to allow credit for the indebtedness incurred to the supply companies and the contractors and other persons who actually furnished funds to petitioner prior to May 1, 1936, its decision is in conflict with the decision of the said Circuit Court of Appeals for the Fifth Circuit in

the case of *Scofield v. Valley Pipe Line Co.*, 138 Fed. (2d) 835.

In *Commissioner v. Haskelite Mfg. Corporation*, 128 Fed. (2d) 902, the taxpayer, in 1933, attempted to borrow money from the RFC. At that time the RFC made loans only through a subsidiary. The taxpayer made application to the subsidiary, which then applied to the RFC which granted the loan in 1934. The collateral furnished by the taxpayer was delivered to the RFC. Taxpayer received $180,000.00 in cash of the loan and the remaining $20,000.00 thereof was used to purchase stock in the subsidiary. A clause in the loan agreement forbade the declaration of dividends. The taxpayer defaulted and the default continued until 1937. In 1936 it applied to RFC for a new loan in the amount of $300,000.00, $200,000.00 of which was to be applied to payment of the indebtedness to the subsidiary. The application was at first denied, but in November, 1936, a loan of $200,000.00 was authorized by RFC. The transaction was completed in 1937. The indebtedness to the subsidiary was discharged at the time the loan was closed. Both the taxpayer's application and the resolution of RFC authorizing the loan, contained provisions prohibiting the payment of dividends until the discharge of the obligation.

In overruling the contention of the Commissioner that the required contract had not been executed prior to May 1, 1936, the court said:

> "The fallacy of the position, however, lies in the fact that petitioner (the Commissioner) treats the transaction between respondent and the RFC in 1936-

> 1937 as a new contract unrelated to the situation previously existing between the same parties * * *. As a matter of fact, there can be little, if any, question but that the transaction between respondent and the RFC in 1936-1937, was in reality, merely a continuation of the loan made in 1934. At all times material to the instant situation, respondent was restricted from the payment of dividends because of a written contract executed prior to May 1, 1936. The fact that a later agreement in identical language reiterated the same restriction does not justify the conclusion that it was a different restriction or that the rights of the parties were altered thereby. The RFC was the actual creditor in both transactions. The principal of both notes was the same. The mortgages and assignments executed in 1937, covered the same property as those executed in 1934."

So, in this case, the fallacy of the position stated by the Circuit Court of Appeals lies in the fact that the court treats the letter of commitment of the bank, the assignment of portions thereof by the petitioner to its materialmen, vendors and contractors, all prior to May 1, 1936, and the execution of the notes to the bank on June 18, 1936, as wholly unrelated transactions. It is entirely clear from this record, however, that all of these steps were part of one and the same transaction. It was known at all times and to all parties involved that the bank had committed itself to loan the necessary money to petitioner to finance the proposed operations of petitioner. The conditions of the commitment were also known, and it was likewise known that petitioner had no assets with which to finance its operations other than the bank's commitment. With the knowledge and consent of the bank, the materialmen, contractors and vendors extended credit to the petitioner in

reliance, not on petitioner, but upon the commitment of the bank. The bank, at all times, was the real creditor. At all times during the period after the assignment of portions of the bank's commitment to the end of the years in controversy here, the petitioner was bound to pay this obligation out of its earnings.

At no time after such assignment could it refuse to take any necessary steps to carry out its obligations under its contract with the bank. It had to purchase properties; it was compelled to build pipe lines; it was forced to purchase supplies and it was essential that it execute the notes to the bank, as successive steps in carrying out its written contract with the bank. It could not refuse to take any one of these successive steps. It was under the compulsion of the contracts of assignment which it had executed to third parties. These contracts, however, were anticipated by both the bank and petitioner; the credit obtained as a result thereof was credit in fact extended by the bank to the petitioner, a part of the indebtedness to the bank which was secured by the earnings of petitioner. The making of the notes was merely the final step, the last formality in the series of steps necessary to make complete the contract entered into by the bank and the promoters in December, 1935 and thereafter adopted by petitioner in January, 1936.

The principle of *Commissioner v. Haskelite Mfg. Corp.*, 128 Fed. (2d) 902 is controlling here, and the decision of the Circuit Court of Appeals in this case in holding that no debt existed prior to May 1, 1936 is in conflict with it.

Moreover, in holding that the contract executed in June, 1936 by the petitioner is a new contract, and is not merely in continuation of the original contracts with the bank and the third parties involved, the decision of the Circuit Court of Appeals is in conflict with its earlier decision of *Scofield v. Valley Pipe Line Co.* (5th, C. C. A.), 138 Fed. (2d) 835. In that case the court was dealing with an agreement under which the earnings were to be applied to debts created after as well as to those created prior to May 1, 1936. It made this statement:

> "The fact that the provision of the contract obligates the earnings and profits to the payment of future, as well as past, indebtedness, does not in any wise prevent its being a complete compliance with the statute. The statute does not require that *all of the earnings and profits* of the taxable year be by the contract devoted to the payment of the debt it refers to. It requires that some of them be, and it gives credit to the extent that they are so applied. There was compliance with it here."

In the instant case the petitioner was obligated to pay practically the entire amount of the loan to third parties who had extended credit in anticipation that the indebtedness owed to them would be refunded and refinanced through the bank, credit that had been extended in reliance upon the bank's promise to make the funds available upon completion of their work.

The obtaining of credit from these parties was one of the steps necessary to the completion of the agreement made by petitioner with the bank. The refinancing of such obligations so made was one of the duties of the bank under its contract. When the notes were executed and the money

paid over to petitioner no new contract was made and no new debt was created. This was simply the final step in the performance of the contract already in existence between the bank and the petitioner. The same debts existed; the same real creditor, the bank, held the contract with petitioner which required petitioner to pay its earnings monthly in discharge of a debt created when it obligated itself to pay its materialmen, contractors and vendors.

The same situation exists here that existed in *Scofield v. Valley Pipe Line Co.*, 138 Fed. (2d) 835, and the decision of the court in this case is in conflict with its decision on the same matter in the *Scofield case*.

CONCLUSION

Had Section 26(c)(2) of the Revenue Act of 1936 been in existence at the time of the negotiations with the bank or had it been in existence at any time prior to the date of the last step taken in the performance of the petitioner's contract with the bank (June 18, 1936) it would have been an easy matter for the petitioner to have complied with the statute with all the nicety now required by the Circuit Court of Appeals. But the act was not passed until four days after the completion of the last step in the performance of the contract. (June 22, 1936.)

Even so, the intention of the parties is apparent, and that intention must govern. It is also apparent from this record that at no time from the execution of the contract

of December 13, 1936 through the years here involved, could the petitioner do otherwise than apply its earnings to the discharge of the debt then anticipated, and actually created prior to May 1, 1936.

The history of the act makes it plain that the intent of Congress was to prevent the accumulation of large undistributed profits by corporations, and to add to the public revenue by taxing the distributed profits in the hands of the stockholders. This object was accomplished by a graduated tax upon undistributed profits and earnings. It was never the intent of the act to penalize a corporation for non-distribution of profits when there was a legitimate need for them in the business. To assure that the need was legitimate, however, the Congress provided certain tests for legitimacy, that is, the need must be evidenced by a written contract executed by the corporation prior to May 1, 1936, and such contract must require the payment of its earnings in the discharge of a debt during the taxable year or that they be irrevocably set aside within the taxable year for the discharge of a debt.

To deny the execution of a written contract by the petitioner prior to May 1, 1936, in this instance and to deny the existence of the debt—to deny that such written contract requires the earnings and profits of the taxable years, here involved, to be applied to the payment of that debt is to ignore the realities of the case and to decide it upon a state of facts which does not exist.

It is therefore respectfully submitted that this case is one calling for the exercise of this Court of its supervisory powers, by granting a writ of certiorari and thereafter reviewing and reversing said decision.

Respectfully submitted,

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